BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 85J-627-KP
ALAN DORFMAN)

For Appellant: S. Derrin Watson
Attorney at Law

For Respondent: Lorrie K. Inagaki
Counsel

O P I N I O N

This appeal is made pursuant to section 18646[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the petition of Alan Dorfman for reassessment of a jeopardy assessment of personal income tax in the amount of $383,490 for the period January 1 to December 19, 1983.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the period in issue.

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The issue on appeal is whether respondent' properly reconstructed appellant's income for the period at issue.

On October 24 and 25, 1983, the Los Angeles Police Department (LAPD) became aware of a bookmaking operation through information provided by two informants. Upon investigation of the operation, it was determined by the LAPD that appellant was either the principal owner or a partner in the bookmaking business.

The following undercover investigation of the operation resulted in several observations. Appellant was seen to make what appeared to be a betting payoff to a previously unknown individual. Further, appellant was observed delivering betting information to another alleged bookmaker. Appellant was also observed making notations in what appeared to the police to be a "pay and. owe* record sheet, a journal of bets made by a bookmaker's customers. Finally, during one of several undercover bets placed by the police, an "employee" of the business indicated that appellant was the owner of the bookmaking group. As a result of these discoveries, a search warrant for appellant's house and car was obtained.

On December 19, 1983, the search warrant was executed. During the search of appellant's residence and vehicle, the police found three journals with football bets recorded therein, a spiral notebook with notations of sport wagers dating back to June 1983, $25,500 in cash, and several sport journals. Appellant was arrested and charged with engaging in bookmaking, occupying a residence for bookmaking, and recording wagers. Eventually, all of the charges were dismissed when the search warrant was quashed.

Based upon the above events and discoveries, respondent determined that appellant had unreported income from bookmaking, the tax of which was jeopardized by delay. Respondent determined appellant's income to be over $3 million for the period January 1 to December 19, 1983, and issued the proposed assessment in question based upon that estimation. Subsequently, appellant submitted a petition for a reassessment, which the Franchise Tax Board (FTB) denied. After a timely appeal to the board was filed, the FTB reviewed its income estimation. Upon careful analysis of its estimation, the FTB redetermined appellant's income based solely upon the "pay-and-owe" records discovered during the search and

seizure of December 19 1983. This redetermination resulted in an income figure of $1,245,101, with a net tax liability of $135,444.11. This income figure was determined without allowing for a deduction of the losing bets'appellant had to pay out to his bettors. Despite this lowered income estimate, appellant maintains that he is not responsible for the amount of tax presently assessed against him.

Appellant's first argument is that there is insufficient evidence to support the conclusion that he received unreported income from bookmaking activities. In support of this position, appellant argues that since the search warrant was quashed, the FTB illegally used the evidence discovered by the. police to determine appellant's alleged involvement in bookmaking.

Respondent may adequately carry its burden of proving that a taxpayer received unreported income through a prima facia showing of illegal activity by the taxpayer. (Hall v. Franchise Tax Board, 244 Cal.App.2d 843 [53 Cal.Rptr. 597] (1966); Appeal of Hee Yang Juhang, Cal. St. Bd. of Equal., Nov. 6, 1985.) The fact that the criminal charges against appellant were dismissed does not indicate that the illegal activity did not occur, but only that the occurrence of the illegal activity could not be proven in a criminal court by admissable evidence beyond a reasonable doubt. (Appeal of Hee Yang Juhang, supra.) As an administrative body, we are allowed to consider the whole record surrounding a case, not just evidence that would be admissible in a court of law. (Appeal of Alfred M. Salas and Betty Lee Reyes, Cal. St. Bd. of Equal., Feb. 28, 1984; Appeal of Marcel C. Robles, Cal. St. Bd. of Equal., June 28,) This consideration may even include evidence that is illegally obtained by the police. (Appeal of Carmine T. Prenesti, Cal. St. Bd. of Equal., Apr. 9, 1985; Appeal of Edwin V. Barmach, Cal. St. Bd. of Equal., July 29, 1981.) The observations by the police listed above confirm respondent's determination that appellant was involved with bookmaking. Specifically, one of the employees of the operation indicated that appellant was one of "bosses" in the bookmaking operation. Furthermore, appellant was found with what were determined to be "pay-and-owe" records commonly used by bookmakers. Consequently, we find that the evidence in the record supports respondent's determination that appellant was involved in bookmaking activities and that he received unreported income therefrom.

The next issue is whether respondent's estimation of appellant's income from those activities is reasonable. Under the California Personal Income Tax Law, an individual is required to report the items of his gross income during the taxable year. (Rev. & Tax. Code, § 18401.) Except as otherwise provided by law, gross income is defined to include "all income from whatever source derived" (Rev. & Tax. Code, § 17071), and it is well established that income received from gambling constitutes gross income. (See Appeal of David and Sarah Seitz, Cal. St. Bd. of Equal., Dec. 13, 1960.)

Each taxpayer is required to maintain such accounting records as will enable him to file an accurate return, and in the absence of such records, the taxing agency is authorized to compute a taxpayer's income by whatever method will, in its judgment, clearly reflect income. (Rev. & Tax. Code, § 17551; I.R.C. § 446.) Where a taxpayer fails to maintain the proper records, an approximation of net income is justified even if the calculation is not exact. (Appeal of Siroos Ghazali, Cal. St. Bd. of Equal., Apr. 9, 1985.) Furthermore, the existence of unreported income may be demonstrated by any practical method of proof that is available and it is the taxpayer's burden to prove that a reasonable reconstruction of income is erroneous. (Appeal of Marcel C. Robles, Cal. St. Bd. of Equal., June 28, 1979.)

Records of a taxpayer's illegal activities may be used by the FTB to reconstruct the taxpayer's income if there is some basis to believe that records discovered during an investigation of a taxpayer's illegal activities relate to those activities. (Appeal of Rosa Gallardo, Cal. St. Bd. of Equal., July 29, 1986.) Respondent's revised estimation of income is based entirely upon the bookmaking "pay-and-owe" records found under appellant's control at the time of his arrest. Furthermore, appellant has not contested respondent's determination that the records reflect bookmaking activities. Consequently, the FTB was justified in relying upon those records for its revised income estimation.

Appellant argues that he was part of a partnership and, thus, should only be attributed with one-half of the income recorded in the "pay-and-owe" sheets. St is the burden of the taxpayer credited with receiving illegal income to prove that a person other than the taxpayer received the income in question. (Gerardo v. Commissioner, 552 F.2d 549 (3d Cir., 1977).) The sole

support for appellant's argument appears to be the assumption by the police that appellant and another individual were partners in the bookmaking operation. The problem with the police investigation was that is focused simply on proving appellant's involvement in the operation, **not whether** partnership existed. Furthermore, considering that appellant was found to have control of the records found by the police, the objective facts indicate that he alone controlled the business. While it appears that others were involved in the bookmaking, appellant has *not* provided convincing proof that a partnership in that business actually existed. Consequently, appellant has failed to carry his burden of proving that he was in partnership with any **other** individual in his bookmaking operation. (See **Gerardo v.** Commissioner, supra.) Therefore, all of the income recorded in the ledgers seized by the police may be assumed to be evidence of appellant's unreported income. (See **Gerardo** v. Commissioner, supra.)

Appellant alleges that respondent failed to deduct from its income estimation, legitimate business expenses he incurted during the period at issue. Appellant has failed, however, to present evidence to this board of his entitlement to those claimed deductions. It is well settled that deductions are a matter of legislative grace, and it is the burden of the taxpayer to prove his entitlement to the claimed deductions. (New Colonial Ice Co. v. **Helvering,** 292 U.S. 435 [78 L.Ed. 1348) (1934).) As unsupported assertions are insufficient to **prove** that a taxpayer is entitled to his claimed **deductions,** respondent's action must be upheld with regard to those deductions. (See Appeal of Joseph W. **Ferrebee,** Cal. St. Bd of Equal.,- Mar. 3, 1987 (87 SBE 015).)

The remainder of **appellant's** arguments deal with the application of federal law to section 17281, California's prohibition against allowing deductions for expenses related to illegal income. Specifically, appellant argues that California, by its adoption of the bulk **of** federal tax law in 1983, has also adopted the theoretical position that gambling losses are exclusions from gross income. In support of his position, appellant cites Winkler v. United States, 2'30 **F.2d** 766 (1st **Cir.,** 1956), the leading federal case espousing this theory. Furthermore, appellant argues that section 17281's prohibition on deducting expenses related to illegal income was **only** meant to apply to those expenses normally thought of as typical office expenses.

Appellant's argument flies in the face of established California law. California specifically rejected the notion that losses were exclusions from income in Hetzel v. Franchise Tax Board, 161 Cal.App.2d 224 (326 P.2d 611) (1958). (See also, Appeal of David and Sarah Seitz, supra.) In reaching this conclusion, the court in Hetzel reasoned that with the enactment of section 23(h) of the Internal Revenue Code of 1939, which treated gambling losses as deductions, the Congress of the United States specifically overruled the reasoning of cases such as Winkler. Since California tax law was based upon federal statutory law, the Hetzel court felt compelled to adopt that rationale as its own. By classifying gambling losses as deductions, the door was open for the Legislature to regulate the deduction as it saw fit. (See New Colonial Ice Co. v. Helvering, supra.) Therefore, the Hetzel court found that section 17359, the forerunner to sections 17291 and 17281, was properly enacted, and that the statute barred the deduction of gambling losses from adjusted gross income. To accept appellant's argument would return our tax laws to a theory disregarded by the California courts and, apparently, the United States Congress.

Appellant's position also disregards the continuity of tax law required by our tax code. Section 17359 was reenacted as section 17297 in 1955, which, in turn, was reenacted as section 17281 in 1983. In each reenacted form, the language of each statute was nearly identical. Section 17028, enacted at the same time that section 17359 was reenacted as section 17297, stated

> The provisions of this code insofar as they are substantially the same as existing statutory provisions relating to the same subject matter shall be construed as restatements and continuations thereof, and not as new enactments.

Section 17028 remained in effect during the 1983 move to conform California tax law to federal law. Thus, it is apparent that the California Legislature intended that the law and rationale prohibiting the deduction of expenses relating to illegal activities remain in effect.

It must also be emphasized that sections 17071 (gross income), 17081, et seq., (deductions from gross income), and 17131, et seq., (exclusions from gross income), the three general sections under which the 1983

conformity with federal law was promulgated, all contain the disclaimer that California will follow federal law "except as otherwise provided in this article." To accept appellant's argument would subordinate California's tax law to federal law in a manner beyond the intent of the Legislature.

Finally, appellant's argument has been rejected by this board in a similar context when section 17359 was reenacted as section 17297. In the Appeal of Bruce A. and Gylberta I. Thomas, decided May 10, 1967, we stated that

> Appellant contends that wagering losses of a professional gambler must be excluded to arrive at gross income. He relies on Winkler v. United States . . . The court there was influenced by limitations which it felt were imposed by the Sixteenth Amendment of the United States Constitution on the power of Congress to provide for taxes on income. That amendment does not apply to the California Legislature ... Subsequent to the Winkler decision, it was held in Hetzel v. Franchise Tax Board .. . that wagers lost by a professional gambler must be regarded as deductions rather than exclusions from gross income. We believe the Hetzel case is controlling on this point.

We believe that the Thomas rationale, as discussed above, is also controlling wrth regard to the reenactment of section 17297 as section 17281. Therefore, we find that respondent correctly applied California law when it refused to allow appellant's gambling losses as deductions.

In summary, we find that the record on appeal supports the elements of respondent's reconstruction of appellant's income for the periods at issue. Given that appellant has the burden of proving that a reasonable reconstruction of her income was erroneous and that he has failed to present evidence to support his claim, we must conclude that respondent properly assessed appellant's income for the year and period in question. (See Appeal of Marjorie Lillie Davis, Cal. St. Bd. of Equal., Apr. 9, 1986.) Accordingly, respondent's action in the matter as modified by the Franchise Tax Board in the manner described above.

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O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the petition of Alan Dorfman for reassessment of a jeopardy assessment of personal income tax in the amount of $383,490 for the period January 1 to December 19, 1983, be and the same is hereby modified in accordance with respondent's downward revision. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 18th day of November, 1987, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Dronenburg and Ms. Baker present.

Conway H. Collis, Chairman

Ernest J. Dronenburg, Jr., Member

Anne Baker*, Member

_____ Member

_____ Member

*For Gray Davis, per Government Code section 7.9